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International Economic & Energy Weekly

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4 October 1985

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DI IEEW 85-040
4 October 1985

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International Economic & Energy Weekly [redacted] 25X1

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DI IEEW 85-040
4 October 1985

Sanitized Copy Approved for Release 2011/03/07 : CIA-RDP97-00771R000807720001-8

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After 10 years of intermittent civil war, Lebanon's economy is probably operating at about 50 percent of its pre-war level. Despite some progress in rebuilding foreign exchange reserves and reviving agricultural production, extensive rebuilding probably will not begin until an overall political settlement is reached. 25X1

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Perspective

The LDC Debt Situation: Rising Frustrations

25X1

Dissatisfaction with chronic financial problems and with IMF-supported austerity programs remains high among debt-troubled LDCs. The general perception in these countries is that their financial obligations have become overwhelmingly burdensome, that living standards have suffered enough, and that reschedulings only postpone, rather than ease, the repayments burden. With little economic improvement in sight, the 11 nations of the Cartagena Group have been examining proposals for interest-payment relief. Even those that have been the voices for moderation are advocating an expansion of lending resources of multilateral financial institutions such as the IMF and World Bank and greater financial participation by developed country governments.

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We believe the challenge currently facing the international financial community is to find a "carrot" that can be used to reward debt-troubled LDCs that undertake substantial structural economic reforms. At present, short-term adjustments—devaluations and cuts in subsidies and wages—are being made, while the fundamental inefficiencies and rigidities of the debtors' economies are going largely unaddressed. Progress in reducing the size and roles of parastatal organizations in the debtor nations, for example, has been quite limited partly because of the vested interests that would be threatened.

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The debtor nations strongly endorse actions that would increase World Bank lending which would help boost growth and development. World Bank officials are just beginning to develop a more catalytic role for the Bank, including cofinancing with commercial banks and more structural adjustment loans, but are somewhat constrained by the Bank's limited resource base. Meanwhile, the IMF remains the focal point for short-term financial assistance. We believe, however, the Fund will resist expansion of its responsibilities because it does not want to be viewed as the "policeman" of the international financial community.

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In our judgment, the debtors will use every available forum to push demands that industrial countries:

- Implement sound economic policies to promote world growth and lower real interest rates.
- Resist protectionist tendencies and open markets to LDC exports.

- Boost multilateral development resources, particularly for the World Bank and Inter-American Development Bank.
- Liberalize some West European regulations, which currently restrict commercial bank lending to LDCs. [redacted] 25X1

For the first time, the LDCs have submitted proposed reforms—including easing conditionality of creditor lending and increasing international liquidity—for consideration at the upcoming IMF/World Bank annual meetings in Seoul. Moreover, the economic and foreign ministers of the Cartagena Group plan to meet soon. Given the current environment, we cannot rule out more radical actions, such as making only partial interest payments to commercial banks. Mexico bears the closest watching. Its IMF program has been suspended, and economic and political pressure, which could intensify if oil prices continue to fall, could make it the first of the big-three debtors—Brazil, Mexico, and Argentina—to confront creditors with alternate solutions. The LDC debtors' response will depend in large part on industrial countries' and commercial banks' actions during the next three months. [redacted] 25X1

[redacted] 25X1

LDC Debtors: Elections and Austerity Programs

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Traditional measures used to stimulate the economy before national elections are causing increasing problems for debt-troubled LDCs, particularly those operating under IMF-supported austerity programs. Increased government spending, hikes in the money supply, or postponement of needed, but unpopular, austerity policies can temporarily brighten the economic picture and voter attitudes. Even when a ruling party victory is assured, the temptation to buy a landslide is strong. Stiff post-election measures, however, are often needed to trim the resulting growth in budget deficits and inflation. Stimulative policies in Mexico and Brazil before elections this year have been prime examples—in Mexico's case, loss of compliance with IMF targets was instrumental in the recent Fund suspension of its program with Mexico. Over the near term, Mexico, Brazil, the Philippines, Venezuela, Jamaica, and South Korea all face important national elections. If past patterns hold, stimulative policies or avoidance of needed austerity measures will likely imperil compliance with Fund-supported programs, or for those under self-imposed programs, complicate relations with creditors.

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Country Patterns

Brazil had its first election of a civilian president in the 1965-85 period this year. Accordingly, little evidence exists to support the theory of a pattern of stimulative policies prompted by presidential election considerations. The money supply, however, does show a jump prior to the 1985 presidential election, which the new government has been reluctant to rein in. The congressional elections of 1982 also provide a vivid example of election considerations determining economic policy. As the elections drew near, previous cuts in government spending were abandoned and monetary policy was relaxed. Moreover, Brasilia needed IMF assistance at the time, but postponed the unpopular move until after the elections.

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The case of ***Mexico*** differs from other countries with regular election histories in that the Mexican Constitution prohibits presidential reelection. The Mexican Government, in an effort to rally support for the ruling party and reduce the need for voting fraud, has often increased expenditures on public works and other projects before elections. It has usually implemented unpopular measures such as exchange-rate adjustments and cuts in public-sector spending after elections. This general trend was obvious before the 1982 presidential elections and last July's midterm elections. In the most recent case, the de la Madrid government's pursuit of stimulative policies was instrumental in the recent Fund decision to suspend its agreement with Mexico.

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South Korea has a well-developed economy and a history of preelection economic stimulation. While money supply data suggest no clear pattern of stimulative policies preceding elections, government spending figures indicate fairly heavy use of pump priming.

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Patterns in the ***Venezuelan*** case are not as obvious. Venezuela's process of political succession is one of the best developed in Latin America. This system would seem to promote expansionary policies aimed at reelection, yet only a weak trend appears. Efforts to improve the party's position focus more on sophisticated campaigns and strong endorsements by top party officials than on increasing expenditures or expanding the money supply.

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In the ***Philippines,*** stimulative measures appeared before the 1965 and 1969 presidential elections. Subsequent elections show no such trend. New austerity measures—including a devaluation of the peso—came just weeks after the May 1984 national assembly elections.

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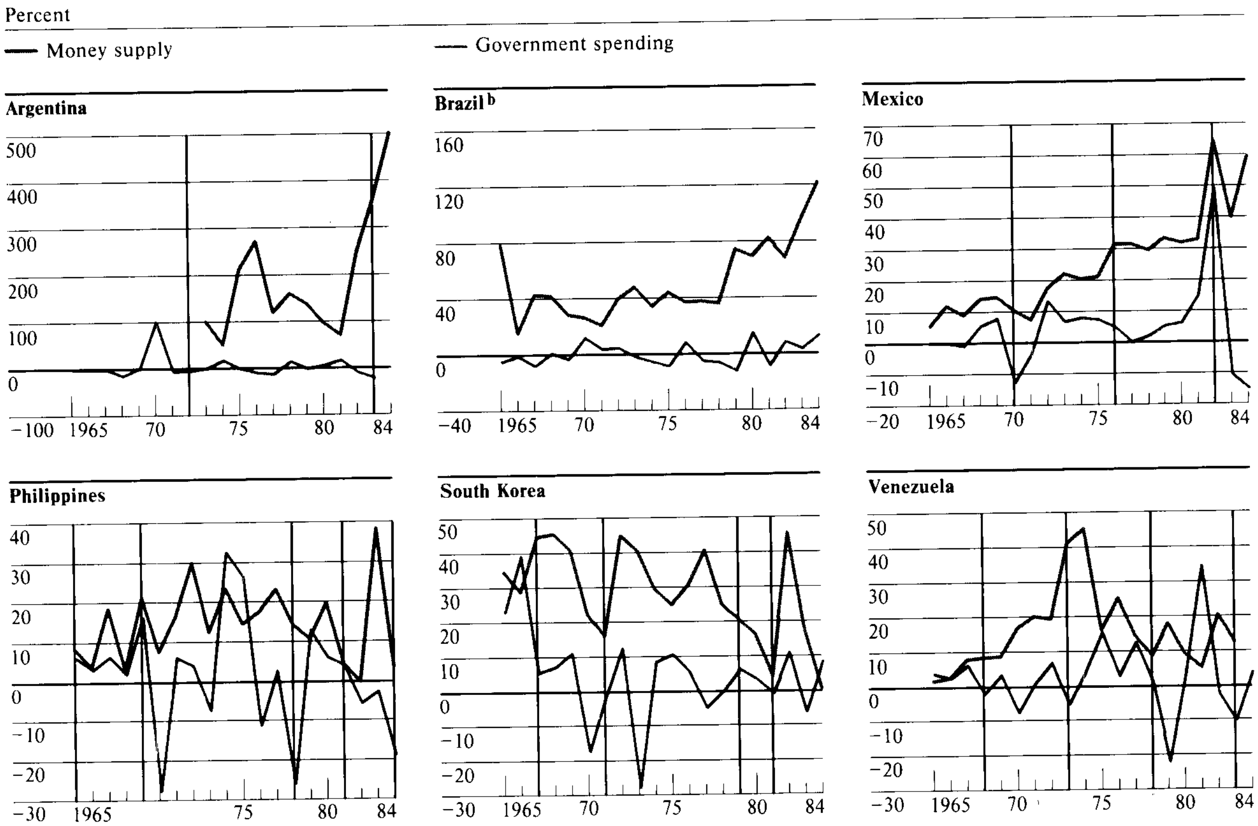
LDC Debtors: Government Spending and Money Supply Growth[a]



[a] Vertical lines represent election years.
[b] Brazil's only election in the last 20 years was in 1985.

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A comparison of spending and money supply figures under various administrations in ***Argentina*** is less revealing than in other cases because of the lack of continuity in Argentina's recent political history. In the last 20 years, there have been as many coups in Argentina as elections. In most cases, irregular and tumultuous political succession has precluded stimulative policies. Figures from the 1983 election, however, do show a large increase in the money supply prior to the election of that year.

Near-Term Outlook

If historical patterns hold, several debtor country governments will increase expenditures and loosen their money supplies before their next elections, resulting in larger deficits, higher inflation rates, and increased difficulties with creditors. 25X1

Municipal elections in Brazil are scheduled for mid-November. We believe Brasilia probably will not take the steps necessary to conclude a new IMF

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agreement—including more extensive cuts in the budget deficit—until afterward to prevent the opposition from exploiting the issue. The impasse with the Fund will continue to cause concern among bankers. [redacted]

In South Korea, national assembly elections are scheduled for 1987. President Chun has promised to step down in 1988. Despite his leaving office, Chun may be compelled to tamper with the economy to effect a favorable election climate for his party. [redacted]

In the Philippines, President Marcos is maneuvering between creditor prescriptions and decaying domestic conditions. Manila met its July IMF targets, but economic difficulties persist, including a projected 15-percent drop in export earnings for 1985. With increasing opposition, Marcos might elect to pursue expansionary policies prior to the 1986 local and 1987 presidential elections. Resulting deficits and inflation, however, would put Manila out of compliance with its IMF agreement and consequently cut off further commercial credit. [redacted] 25X1

Two other countries face elections within three years. Mexico's President de la Madrid is likely to pursue somewhat more expansionary policies prior to next year's gubernatorial elections and, more notably, before the 1988 presidential election. Efforts to reflate the economy for the presidential election are likely to begin in mid-1987, possibly at the time presenting major problems for Mexico with its international creditors. [redacted] 25X1

Venezuela faces elections next in 1988. Though it is not currently under an IMF agreement, it is being monitored by the Fund, and serious increases in government spending and inflation could complicate agreements with commercial creditors. [redacted] 25X1

Finally, Jamaica recently renewed its agreement with the IMF, rescheduled debts to foreign commercial creditors, and made progress in reducing its deficit. Jamaica, however, still faces a 50-percent debt service ratio, and resistance to further austerity measures is growing. Should the government fail to improve the performance of the economy before the next general election—which constitutionally must be called by December 1988—the opposition's prospects would be strengthened. [redacted] 25X1

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[redacted] 25X1

Lee Kuan Yew's Singapore: Is the Magic Fading? [1]

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Lee Kuan Yew's visit to Washington next week coincides with a rare period of economic and political turbulence for the island republic. The sudden plunge of Singapore's GDP growth rate from 10 percent (at an annual rate) in first quarter 1984 to minus 1.4 percent in second quarter 1985 is unprecedented. In addition, the relatively poor showing of Lee's People's Action Party (PAP) in the December 1984 election has encouraged many among the traditionally docile populace to defy the government and actively support opposition positions. While Lee is setting the stage for a transfer of political leadership from his generation to the next, the process may be delayed if Singapore's economic troubles persist.

The Growth Slowdown

In the 25 years since independence, Singapore has been a model for Third World economic development. It has become the world's second-busiest port, second-largest builder of offshore drilling rigs, third-largest oil refining center, third-largest ship building and repair center, and the commercial, financial, and communications hub of Southeast Asia. During 1961-81, Singapore averaged 9.2 percent annual real GDP growth—far outpacing growth in developed nations.

Annual growth in 1985, however, is expected to reach 2 percent at best, and the economy may even contract—for the first time. Business failures are rising in all sectors. Unemployment also is on the rise: more Singaporean workers lost their jobs in the first five months of 1985 than in all of 1984.

The manufacturing sector has been hardest hit, primarily because of stagnant US demand for electronics products and computer peripherals.

Lee Kuan Yew
Shrewd, sophisticated, and tough minded . . . anticipates and attacks problems head-on . . . brooks little opposition . . . known for personal and official honesty and efficiency . . . strong supporter of continued US presence in Asia.

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Petroleum refining faces dwindling production as world oil prices fall and Indonesian and Middle Eastern producers develop their own refineries. In addition, traditional entrepot trade has suffered because Singapore's ASEAN partners are improving local shipping and marketing sectors. Shipbuilding and repair, for the same reasons, have been in deep depression for almost a year. 25X1

Other sectors affected by the slowdown show no sign of quick turnaround:

- Textiles and other labor-intensive manufacturing industries are shifting operations to neighboring countries such as Malaysia and Hong Kong where labor costs are cheaper. 25X1
- Tourism and retail trade have suffered as Thailand, Indonesia, and Malaysia have dramatically increased taxes on visitors and shoppers going to Singapore.
- A surplus of office and hotel space has significantly slowed construction activity. Because bank loans have been heavily concentrated in construction, the finance industry is suffering as well. 25X1

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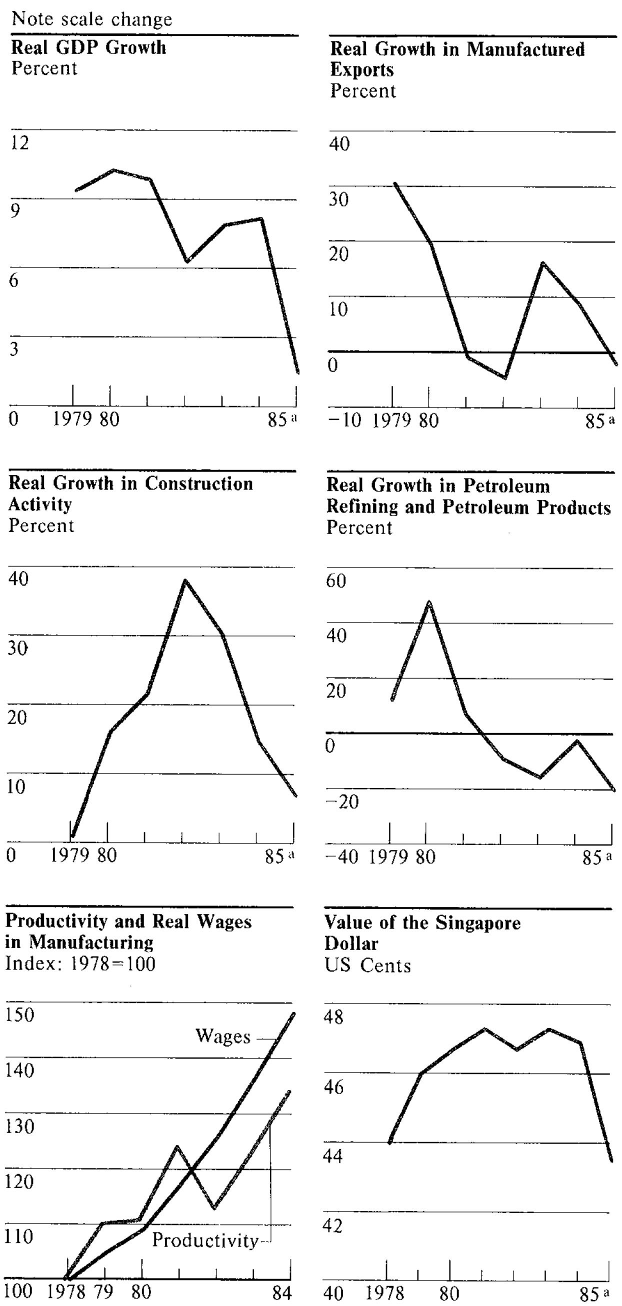
Singapore: Economic Indicators, 1978-85



[a] Estimated.

[b] Productivity is real manufacturing output divided by number of workers in manufacturing. Real wages are real earnings per worker per hour.

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Initial Steps To Ensure Economic Resurgence

Lee has tried to direct Singapore's resources toward high-technology enterprises, hoping to capitalize on the nation's comparative advantage in highly educated and skilled workers. His first reaction to the slowdown was to provide seed money early this year to newly created firms to invest in high-risk, high-technology ventures—typical of his long-term strategy of moving the country up the technological ladder. The government also offers special investment, tax, and export incentives to high-technology ventures. 25X1

In July, however, Lee Hsien Loong, chairman of the Economic Committee formed early this year and elder son of Lee Kuan Yew, assessed the slowdown in terms critical of previous government planning. Lee admitted that the relatively high cost of doing business has eroded Singapore's competitive edge—something the government has long refused to acknowledge. The remedies he announced were:

- Reducing charges for some communication, transport, and real estate services provided by the government.
- Partially rebating business property taxes.
- Lowering interest rates for some small business loans.
- Accelerating public construction projects.
- Allotting an additional $45 million of venture capital for investment in high technology.
- Halting government land sales for two years to shore up the property market. 25X1

The government initially held the line against business complaints about high wages, which, since 1980, have risen at an average rate of 8 percent annually. Singapore's labor costs are now almost 70 percent above the next highest in the region, Hong Kong. 25X1

In his National Day speech on 18 August, Lee called for a voluntary two-year freeze on wages—a sharp reversal of six years of policymaking. At the same time, Lee reassured his countrymen that,

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Singapore's Wage Policies

Since 1979 the National Wages Council has recommended annual pay increases above national productivity gains in order to force capital intensification and boost productivity. The Skills Development Fund—which sponsors enterprise-level training programs—has penalized labor-intensive industries with less-skilled employees by collecting higher contributions from employers whose workers earn less than a certain annual wage. In addition, the Central Provident Fund—a retirement scheme—collects one-fourth of a worker's annual salary from the employee and one-fourth from his employer and accounts for 40 percent of wage costs in Singapore.

while the present economic transition is painful, recovery is achievable by 1987, barring world recession. He encouraged business to redirect efforts away from sectors with bleak futures, such as shipbuilding and oil refining, toward such promising ventures as biotechnology and specialty services in engineering design and medicine. Although Lee's message contained little new—almost all of Singapore's unions had already agreed to forgo pay increases this year and businesses are being forced by market realities to reallocate resources as he suggests—it was favorably received.

The Economy and the Succession

Lee believes, in our judgment, that securing his reputation requires reversing the current downslide and putting the economy securely back on the fast track. He wants to assure himself that his dream for Singapore—achieving an economic status equal to that of Switzerland by 1999—is within reach.

To do this, Lee almost certainly believes he must engineer a smooth transition of leadership to a new generation so that a quarter century of careful economic policy making will not be "recklessly overturned." Lee has encouraged a gradual rejuvenation of the ruling party, rejecting the Chinese tradition of lifelong service for high-ranking officials. He is proposing that government officials retire at age 65. Lee himself will be 65 at the time of the 1988 elections and has said he will step down then. Accordingly, he has placed several promising young technocrats—typically Singapore born, holders of advanced college degrees, and recruited from a local corporation or profession—in party and government positions to test their capacity for leadership. 25X1

Nonetheless, Lee appears ambivalent about turning over the reins to the young technocrats he has recruited. Throughout the 1970s and early 1980s, 25X1 he made every major policy decision himself, rarely consulting anyone other than a few close advisers. While younger politicians are taking a higher profile in Parliament and in public, when circumstances warrant he has not hesitated to turn to respected leaders of his own generation in devising strategy. Lee underscored his lack of confidence in the younger generation of his party by introducing his elder son, Lee Hsien Loong, into Parliament as a junior minister in 1984 and making him head of Singapore's new Economic Committee. 25X1

Furthermore, Lee is preparing to reserve a role for himself in future governments to ensure economic policy continuity. At Lee's behest, the Cabinet is 25X1 drafting a constitutional amendment to make the now honorary presidency an elective position with the power to veto government spending of foreign exchange reserves accumulated by previous governments. Lee probably intends to move into this watchdog position after the 1988 elections if he settles on a successor, which would enable him to turn over the day-to-day management of the economy while still retaining substantial control. 25X1

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More Initiatives on the Horizon

We believe Lee will continue to direct economic relief measures principally toward business. Nevertheless, he opposes several of business's primary demands:

- He has vowed not to lower retirement fund contributions because these contributions fund public housing and other important government projects.

- Because Lee is resolved to sustain the government's budget surplus, observers in Singapore discount the possibility of substantial tax breaks, even though corporate taxes—at 40 percent—are the highest in the region.

- Businessmen have asked the government to relax the Central Bank's heavyhanded regulation of investment loans—saying it inhibits local entrepreneurs—but government officials recently took advantage of a bank collapse in Hong Kong to justify stringent bank regulation.

- Businessmen argue that offshore banking regulations are less rigorous and tax laws favor foreign investors. Lee, however, believes that keeping up with world technological improvements is the only way for Singapore to remain prosperous.

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There are hints that the government may be softening its hard line on other issues. Workers may now use their retirement fund accounts to purchase more than one residential property and may soon be able to use these savings to invest in nonresidential property such as offices, shops, factories, and warehouses. According to press reports, the government is also considering allowing workers to use their retirement fund accounts to purchase selected domestic blue-chip stocks. Moreover, reports are multiplying that the government will make good on its promise to list state-owned companies publicly, beginning with Singapore International Airlines—an initial step toward privatization

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Outlook

In our judgment, Lee's relief policies to date are less a blueprint for economic recovery than a message that recovery depends on individual initiative. We expect Singapore's growth rate to turn upward before the end of the year but believe the recovery will require significant industrial restructuring over the longer term. Thus GDP growth during the next two years is unlikely to return to traditional levels of 8 to 9 percent annually.

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We judge that Lee will not hesitate to hang on to the reins of government if he believes that the people are hesitant to follow the younger leaders or that the younger leaders are improperly asserting their authority. Lee may decide, furthermore, that he is the only person with enough political power and charisma to bring Singapore out of its economic slump—a judgment we think he is likely to make if the slump continues. Even in the best of circumstances, we believe Lee is unlikely to turn power over to the younger generation without retaining a watchdog role for himself.

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Trinidad and Tobago: Downside of the Oil Boom

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Trinidad and Tobago's oil-based economy—once the envy of the Caribbean region—has experienced a cumulative decline in real GDP of 17 percent since 1982 and faces much harsher austerity in the coming years. The Chambers government—worried about the record-low popularity jeopardizing the ruling party's nearly 30-year hold on power—has taken only piecemeal actions to deal with the country's hemorrhaging foreign exchange reserves. The private sector is too small to take the lead in creating new jobs or generating new sources of foreign exchange. Even the Caribbean Basin Initiative and other US trade benefits are unlikely to spark much growth in nonoil exports as long as labor costs remain high and the Trinidadian dollar remains overvalued. Trinidad will likely postpone severe belt tightening until elections are held, probably by late 1986. Such foot-dragging, however, will merely make the adjustment process more difficult no matter who wins.

From Prosperity to Austerity

Led by the oil sector, Trinidad has long had the largest economy in the English-speaking Caribbean and one of the highest standards of living in the Western Hemisphere. Between 1975 and 1982, the country's real GDP grew at an average annual rate of 5.4 percent, compared with a weighted average of 2.5 percent for the rest of the Caribbean region. By 1980, the booming petroleum sector contributed 42 percent of GDP, more than double the 1972 share, and 90 percent of the country's export earnings. With its new-found wealth, the government initiated a number of capital-intensive, export-oriented projects and even became a major aid donor to its less prosperous neighbors.

By the end of 1982, however, Trinidad's growth stalled and real GDP fell in the next two years under the weight of the international oil glut and declining oil prices. The country's petroleum refineries operated at less than 25 percent of capacity during 1983 and 1984, mainly due to reduced US demand. In addition, manufacturing suffered from declining domestic demand. Export competitiveness was badly eroded by high labor costs and a steady appreciation in the real exchange rate—largely because of the linkage of the Trinidadian dollar to the soaring US dollar. Construction activity also sagged as large-scale investment projects were completed and government expenditures on new projects were slashed. Agriculture continued to suffer from prolonged neglect. 25X1

Remedial Actions

Government responses so far have concentrated on reducing the country's internal and external payment deficits. Between 1982 and 1984, the government's budget deficits as a share of GDP declined five percentage points to 7.6 percent as spending 25X1 cuts—mainly in capital outlays and net lending—more than offset declining revenues. Overall revenues reportedly have been far below expectations this year because of lower business earnings and inefficient methods of tax collection. 25X1

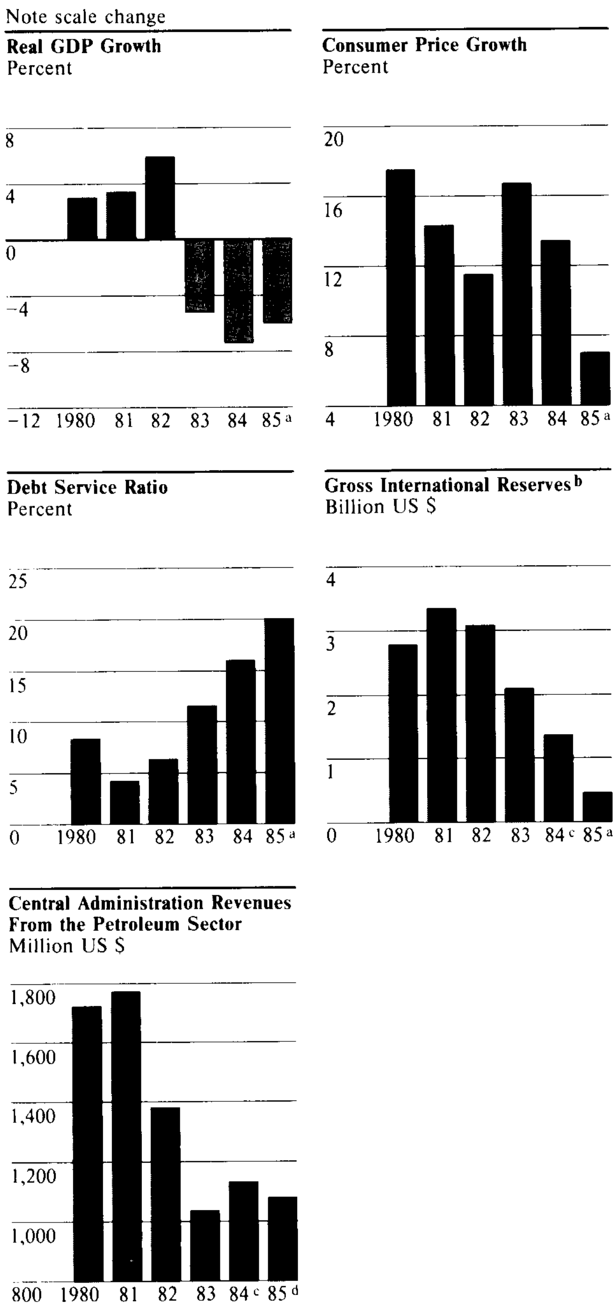
The government has concentrated on trying to conserve foreign exchange reserves. For example, in October 1983 the government introduced exchange controls to slow reserve losses that totaled nearly $1 billion for the year. Ceilings were placed on the availability of foreign exchange to purchase specific imports. To protect local producers, licenses also were required for over 400 imports. In 1984, these restrictions and reduced capital expenditures by the government contributed to a 26-percent decline in imports. A slower—but still serious—outflow of foreign reserves continued, and new taxes on im- 25X1 ports and foreign travel were introduced this year. Although the government accelerated foreign borrowing in recent years to help cover its payment shortfalls, evidence suggests that heavy capital flight more than offset such inflows. [redacted] 25X1

Economic diversification has moved slowly even though the Industrial Development Corporation (IDC) indicates existing oil reserves are likely to be depleted in 10 years. [redacted] 25X1 Trinidadian officials have also publicly touted the CBI as an investment lure, but privately [redacted] 25X1 have become increasingly frustrated with the lack of visible results from the program. 25X1 [redacted] 25X1

Trinidad's economic bind has even prompted the government to explore expanded ties to Cuba and the Soviet Union, but it is moving cautiously. In late 1984, Trinidad entered into a $15-million reciprocal trade agreement with the Castro regime. [redacted] Havana 25X1 has tried to take advantage of Port-of-Spain's economic plight and gain a diplomatic presence in Trinidad by claiming that, once more "normal" relations are in place, Cuba would expand its purchases of Trinidadian products. Trinidad also has considered a Soviet request to establish a resident office, according to a fairly reliable source. [redacted] 25X1

Despite the government's efforts, US Embassy reporting indicates the downward economic spiral continues this year. [redacted] 25X1 25X1 unemployment is about 25 percent and expect the rate to hit 30 percent by the end of this year. Meanwhile, foreign currency reserves have dropped from a peak of $3.3 billion in 1981 to $550 million. [redacted] 25X1

Trinidad and Tobago: Economic Indicators, 1980-85



a Projected.
b End of year.
c Preliminary.
d Budgeted.

[redacted] 25X1

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Trinidad and Tobago: Balance of Payments *Million US $*

	1980	1981	1982	1983	1984 [a]	1985 [b]
Current account balance	347.0	364.9	−813.3	−1,091.6	−670.1	−500.0
Merchandise balance	547.9	626.0	−526.6	−468.7	208.8	500.0
Exports (f.o.b.)	2,541.7	2,607.8	2,224.8	2,108.3	2,115.0	2,100.0
Imports (c.i.f.)	1,993.8	1,981.8	2,751.4	2,577.0	1,906.2	1,600.0
Net services	−200.9	−261.1	−286.7	−622.9	−878.9	−1,000.0
Capital account balance	324.3	314.4	555.4	344.7	434.1	450.0
Total public-sector borrowing	179.0	197.0	324.0	251.0	58.0	350.0
Direct investment	125.5	167.1	210.5	164.5	300.6	150.0
Other	19.8	−49.7	20.9	−70.8	75.5	−50.0
Errors and omissions [c]	−42.1	−126.5	−11.5	−230.0	−511.7	−850.0
Allocation of SDRs	11.3	10.7	0	0	0	0
Change in gross reserves	**640.5**	**563.5**	**−269.4**	**−976.9**	**−747.7**	**−900.0**
External debt, yearend	771.0	968.0	1,292.0	1,543.0	1,601.0	1,925.0

[a] Preliminary.
[b] Projected.
[c] We believe the large "errors and omissions" component in official Trinidadian statistics includes heavy capital flight.

[redacted] 25X1

[redacted] 25X1

Obstacles to Adjustment

Despite Trinidad's recent aggressiveness in pursuing foreign investment, formidable roadblocks work against quick progress. High labor costs particularly discourage foreign investors. According to IMF data, unit labor costs in nonoil, nonsugar manufacturing nearly doubled between 1980 and 1984, while productivity rose only 8 percent [redacted]

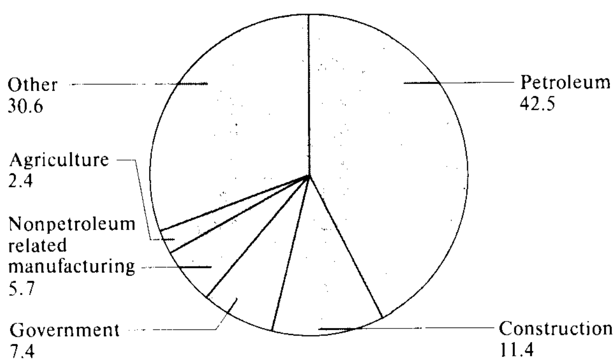
A number of US businessmen have told US Embassy officials that Trinidad has not acted fast enough to create a proinvestment climate. The prohibition against sole foreign ownership of an enterprise is a major disincentive. Many foreign investors, aware of the government's history of imposing onerous restrictions on selected firms, are wary of entering into joint ventures. For example, the US-based Tesoro Petroleum Corporation for years was not allowed to retain any earnings in its joint venture with the government. In 1982, Tesoro finally decided to sell its 49.9-percent share to the government, but a price agreement has yet to be reached. [redacted] 25X1

Trinidad's nonoil export sector faces other obstacles. Aside from high wages, the 68-percent appreciation in Trinidad's real exchange rate between 1980 and 1984 has caused export prices to soar in terms of other currencies. Devaluation, however, is 25X1 opposed by government and business leaders, who, according to US Embassy reports, believe it would raise import prices while only modestly increasing export earnings because most sales are priced in US dollars. [redacted] 25X1

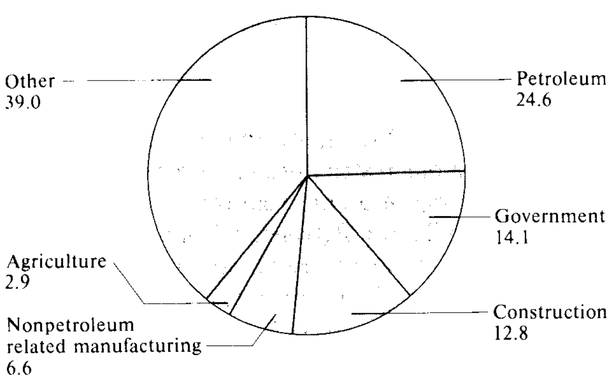
Trinidad and Tobago: Share of GDP[a] by Sector, 1980 and 1984

Percent

1980



1984[b]



[a] At factor cost.
[b] Estimated.

[redacted]

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The government's heavy involvement in the economy also poses obstacles to adjustment. During the oil boom in the 1970s, the government invested heavily in costly energy-intensive industries, expanded its equity position in foreign-owned firms, and absorbed unprofitable businesses. Unwilling to eliminate jobs, the government has failed to streamline most of these companies and has been reluctant to transfer ownership if layoffs would result. Today the state controls approximately 80 percent of the economy through 64 joint or wholly-owned enterprises. According to official data, only seven of these firms operated profitably in 1984. [redacted] 25X1

Moreover, huge government subsidies have supported some hopelessly insolvent enterprises. In recent years, such subsidies have even exceeded 10 percent of GDP, according to IMF data. The ISCOTT steel plant has absorbed $500 million in government support since its 1981 startup and has never operated above 30 percent of capacity. In order to protect the nearly 3,500 jobs that would have been eliminated by the closure of the Texaco refinery at Pointe-a-Pierre, the government purchased the $189 million facility last March. In the following three months, the refinery incurred losses of $21 million. [redacted] 25X1

The Chambers administration shows no sign of reversing these policies. In fact, [redacted] 25X1 25X1 government's financial bind and bad publicity surrounding the huge public-sector losses, however, have prevented implementation of the plan.

[redacted] 25X1

Grim Prospects

We believe the economy will continue to decline over the next few years, worsening already serious unemployment and foreign payment problems. The government expects its 1985 revenues from the petroleum sector to be only 60 percent of the peak 1981 level. We believe that revenues will also continue to be hurt by lower nonoil business earnings and inefficient tax collection. As a result, Trinidad will be tempted to substantially increase its foreign borrowing and debt service burden. Moreover, the worrisome investment climate probably will retard economic diversification. We believe the CBI will be of little benefit as long as 25X1 labor costs and the exchange rate reduce the competitiveness of exports. Extensive public ownership ensures that economic decisions will continue to be based heavily on political considerations. Even a dramatic increase in Soviet or Cuban trade, which seems unlikely, probably would be insufficient to reverse the country's economic slump. [redacted] 25X1

The weakening economy will continue to erode support for the ruling party, which is facing a serious challenge from a unified opposition. The National Alliance for Reconstruction—a moderate, broadly-based coalition—already enjoys a substantial lead over the ruling People's National Movement in opinion polls. If the 1985 fiscal deficit exceeds the budget forecast—as we expect—the government will have to grapple with the need for much harsher austerity in the coming months. Until now, workers' concerns over losing their jobs have largely muted labor unrest. After the elections—which must be held before February 1987—we believe the potential for unrest will grow as new austerity measures take effect. [redacted] 25X1

[redacted] 25X1

Iran: Political Debate Over Foreign Exchange Crisis [redacted]

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Sagging oil sales and low foreign exchange reserves have forced drastic reductions in imports since the beginning of the year and have led to a bitter debate within the government over the control of foreign trade. The shortage of hard currency has caused depressed industrial output to fall even further and threatens more cuts in an already-austere development program. Prime Minister Musavi's government, made up largely of radicals, has been blamed for mismanagement and corruption by the more conservative Consultative Assembly (Majles) and by the Iranian press. General discontent over the economy remains high within the Revolutionary Guard and the merchants—both key interest groups. Tehran's concern over the vulnerability of its oil exports has spurred efforts to raise foreign exchange reserves, and this is likely to aggravate problems in the near term. [redacted]

Imports Slashed

Iran has slashed imports in the face of low oil revenues to avoid drawing on its limited foreign exchange reserves. Imports in the first three months of 1985 from OECD countries—about two-thirds of total imports—were down 46 percent from the same period in 1984. The trend has continued into the summer. Numerous press reports indicate rising complaints by Iranian importers about difficulties obtaining government permission to import goods. [redacted]

Foreign exchange shortages have even forced Tehran to restrict cash purchases of some items it considers high priority [redacted] in June, for the first time, Iran requested delayed payment terms on purchases of medical supplies. Moreover, Western banks have tightened letter of credit procedures for customers dealing with Iran [redacted] Press reports indicate many firms stayed away from the Tehran International Trade Fair in early September because they believed business opportunities did not justify the expense and personal hazards involved. Foreign firms in Iran report that in the past two weeks Tehran has clamped down hard on remaining imports and currency transfers abroad. The firms describe the current foreign exchange crisis as the most severe since the revolution. [redacted] 25X1

Tehran's difficulties over the past several months are directly linked to the soft oil market. Iranian exports to OECD countries in the first quarter of this year were down 47 percent from the first quarter last year. We estimate oil exports—about 95 percent of foreign exchange earnings—averaged only about 1.5 million barrels per day (b/d) during the first six months of the year compared with about 2.0 million b/d in the same period last year. Oil prices also have dipped, with spot prices of Iranian light falling from around $27 per barrel in June 1984 to about $25 this June. Iraq's current bombing campaign against Khark has made a bad situation worse. [redacted] oil shipments out of Khark have been interrupted by recent attacks, and Tehran is increasingly frustrated over its inability to defend the island. [redacted]

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Shoring Up Revenues

The attacks on Khark Island have highlighted Iran's need to maintain its dwindling foreign exchange reserves. We estimate Iran's foreign exchange reserves currently stand at $4-5 billion, but only about $2 billion is readily accessible. At least $1 billion is tied up in negotiations over the fate of a loan made by the former Shah to the French Government; another $1.5 billion is illiquid or in the form of uncollectable loans to Third World countries. Readily accessible reserves are sufficient to maintain the current low rate of imports for 2 to 3 months if revenues are completely cut off. [redacted]

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Since the beginning of this year, Tehran has sought to limit the drain on its foreign exchange reserves to avoid turning to foreign credit or cutting essential imports in an emergency. The Majles had hoped to bolster reserves though a provision in the recently passed Foreign Exchange Budget Bill requiring 10 percent of all foreign exchange receipts to be set aside in a Special Emergency Reserve Account with the Central Bank. At current revenues, however, this measure would only increase import coverage by about three weeks in the first six months. [redacted]

Efforts to boost nonoil exports have foundered. An overvalued rial has been a major obstacle. The government pays exporters at the official exchange rate for foreign currency—they would earn six or seven times more at black-market rates. Preferential exchange rates on nonoil exports and other incentives were included in the Majles' foreign exchange bill passed this summer, but are still pending approval from the Council of Guardians. Nevertheless, the Central Bank, which would oversee implementation, reportedly is unwilling to offer exchange rates near market rates for fear of increasing inflation. At any rate, because nonoil exports are only a small share of the total, any boost probably would not add significantly to Iran's revenues. [redacted]

Economic Impact

Reduced imports have lowered domestic production, aggravated a general scarcity of consumer goods, and slowed development. [redacted] most goods are available only at high black-market prices. Shortages of raw materials and spare parts have cut production or caused outright closings in many industries. In July, Heavy Industries Minister Nabavi said that lack of foreign exchange caused average monthly production for March through June to fall 24 percent compared with the same period a year earlier, according to Iranian press. Articles and editorials in the Iranian papers are especially critical of the many layers of bureaucracy created to conserve foreign currency. [redacted]

Development programs are being cut further at a time when some public services are already at a postrevolutionary low. Industrial development has been particularly hard hit. This is sparking increasing criticism from proponents of industrial growth and, ironically, frustrating plans for greater self-sufficiency. Minister of Industry Shafei recently complained in a report to the Majles that meager foreign exchange allocations to the industrial sector are to blame for the failure of his Ministry's plans. The Minister warned that current allocation rates provided only 10 percent of the foreign currency needed for this year's planned projects. [redacted] 25X1 25X1

Political Repercussions

Conservatives blame mismanagement and corruption for many of Iran's foreign exchange problems, and they have used these charges to discredit their radical opponents in Musavi's government. During debate on this summer's foreign exchange bill, members of the Majles criticized the government for deviating from official import priorities. They cited examples such as a letter of credit for vital oil industry equipment that took months while one for television components took only a few weeks. Press reports indicate that political clout, bribes, and outright mistakes have resulted in some commodities being overordered while critical components have not been ordered in time. [redacted] 25X1 25X1

The more conservative Majles has capitalized on the government's inability to manage the economy by seeking a greater role, especially in foreign trade. In August, the Majles passed bills requiring that representatives of the assembly be admitted to sessions of the Foreign Exchange Appropriations Committee, and that the government publicly disclose details of foreign exchange expenditures. In addition, the legislature recently directed the Oil Ministry to report oil revenues monthly and forecast receipts three months in advance. Most government officials oppose this interference. They are concerned that, if ratified by the Council of Guardians, these and other actions by the Majles would impair the Cabinet's ability to act decisively. [redacted] 25X1 25X1 25X1 25X1

The government's public image has suffered from poor management and corruption. Efforts to conserve currency and the resulting depression of economic activity have increased dissatisfaction with the regime among key interest groups. [redacted]

drive to at least maintain foreign exchange reserves will spur Iran's program to cut imports. Prime Minister Musavi recently announced that taxes and government-controlled prices are likely to rise, according to the Iranian press. Stricter government controls on trade will open even greater opportunities for corruption and will spur black-market activity. These factors are likely to further erode popular confidence in the government. [redacted] 25X1 25X1

[redacted] 25X1

Outlook

Low foreign exchange reserves, combined with a weak oil market, will keep Tehran's economic margin thin. A lengthy shutdown of Kharg Island would reduce oil exports by at least 75 percent and would be economically debilitating, especially if combined with renewed strikes or a poor fall harvest. [redacted] 25X1

The economy is by far the most divisive issue facing the government, and increased political infighting over distribution of the shrinking economic pie is likely to open wider rifts between opposing factions. Radicals will probably bear the brunt of the political heat, and the Majles will be able to further expand its power. Moreover, government mismanagement and lower revenues will increase reliance on the private sector, thwarting radicals' plans to increase centralized planning and direction. [redacted] 25X1

Reduced operations at factories could lead to renewed labor unrest, if leaders emerge to organize workers [redacted] workers' purchasing power has already fallen by at least 35 percent since the revolution. The regime remains wary of a repeat of the strikes that occurred earlier this year. The Minister of Labor recently expressed concern over acts of sabotage in Iran's production units and warned workers against political activities. [redacted] 25X1 25X1

General discontent over lower levels of imports and the state of the economy will probably increase. Moreover, attacks on Kharg Island and Tehran's

Lebanon: Economy Down But Not Out

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After 10 years of intermittent civil war, Lebanon's economy is probably operating at about 50 percent of its prewar level. In the last year, inflation has jumped to about 75 percent, the Lebanese pound has depreciated by 60 percent, and government debt has grown by over one-third. Much of Lebanon's economic infrastructure has been damaged or destroyed, many of its most skilled people have emigrated, and the country is cut up into sectarian zones of influence. The government still provides some services, bankrolls a bloated payroll, and collects limited taxes and fees but cannot rule the country. Despite some progress in rebuilding foreign exchange reserves and reviving agricultural production, extensive rebuilding probably will not begin until an overall political settlement is reached.

Borrowing To Stay Alive

In Lebanon, government spending not only primes the pump, but also provides much of the fuel to keep the economy running. According to the US Embassy, government spending, through its payroll and a few public works projects, is one of the main reasons the economy remains afloat. Unfortunately, spending has continued to grow, while revenues have dropped to practically nothing.

Revenue from customs receipts, formerly the main source of funds, was budgeted at about 3 billion pounds ($160 million)[1] for 1985. The government's plan to take over illegal ports last fall was largely a failure, however. Customs duties for the first half of 1985 totaled only 200 million pounds ($10 million), less than 15 percent of what was needed to meet the budget. Nonetheless, expenditures, originally budgeted at 11.4 billion pounds ($600 million) for 1985, were upped at midyear to 12.4 billion ($650 million)—and could go higher.

Typical of the straits in which the government now finds itself, the Ministry of Finance has recently stopped paying for imported crude and petroleum products in an effort to force the cabinet to cut petroleum subsidies. The Director General of the Ministry stated that the petroleum budgetary deficit will probably exceed 11 billion pounds ($600 million) this year and that about 25 percent of locally produced and imported petroleum products were illegally reexported to other Mediterranean countries. According to official statistics, the port of Beirut alone imported enough petroleum in 1984 to satisfy Lebanon's total domestic demand. At the same time, there have been stories of entire shiploads of Lebanese products going abroad. 25X1

While the Ministry hopes to force the Cabinet to double petroleum prices, the Central Bank apparently tried similar tactics several months ago and failed. The Ministry's move itself is likely to boost petroleum prices sharply but also cause considerable confusion and petroleum shortages. In addition, renewed sectarian clashes may result if the Muslim militias perceive the fuel shortages as a Christian plot. 25X1

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According to the Central Bank, the overall government deficit amounted to 9.2 billion pounds ($480 million) in 1984—almost 50 percent higher than the 1982 level. The 1984 deficit equaled over one-third of Lebanon's estimated GNP, one of the highest shares in the world. The deficit for 1985 will likely again set a record, probably well over 10 billion pounds ($530 million) 25X1

25X1

Government debt grew from 30.5 billion pounds ($1.6 billion) at the end of 1984 to 40.7 billion pounds ($2.1 billion) at the end of July, and debt service now accounts for about one-fourth of total government expenditure. So far, the government has had no problem in funding its deficit because 25X1

[1] All pound figures are converted into US dollars at the current rate of 19 pounds to the dollar.

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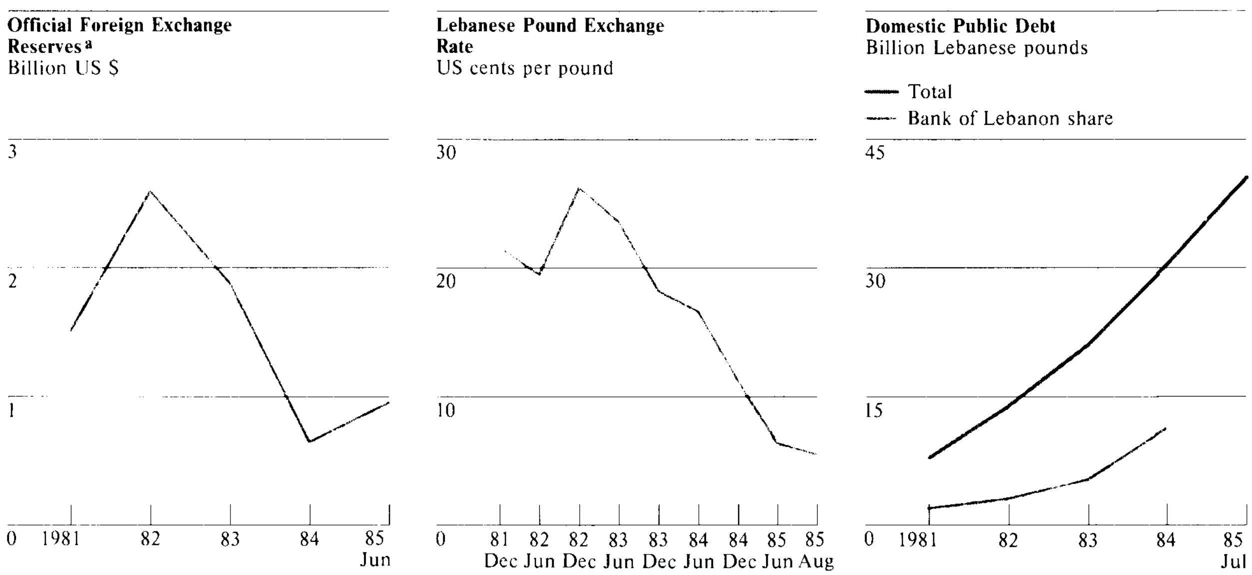
Lebanon: Selected Financial Data, 1981-85



[a] End of year, unless otherwise stated.

[redacted] 25X1

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Lebanese banks have few local investment alternatives. The cost of borrowing has risen steadily, however, with average rates on treasury bills now around 17 to 18 percent. [redacted] 25X1

The Economy Hangs On

According to the US Embassy, industry continues to function, albeit at a very low level. The unstable security situation keeps industrialists from expanding capacity, maintaining large inventories, or even anticipating future sales. In addition, the fighting keeps workers from their jobs and holds down the number of shifts during calm times because workers can only get to and from their jobs during daylight hours. Credit limitations and the drop in the value of the pound have hurt manufacturers' ability to import raw materials. Tax-free goods brought in through the illegal ports also make many domestic products uncompetitive. Despite these adverse conditions, some industries have prospered by flexibly adapting to existing conditions. Profitable industries reportedly include ready-to-wear clothing, electrical fixtures, publishing, wine, fruit juices, and jewelry. [redacted] 25X1

Commercial activity has been hurt by the contraction of local demand, credit limitations, and fear of damage to stocks. On the other hand, it has been helped by a lively trade in smuggled goods going to Syria. While the actual extent of this trade is not known, it has been variously estimated to be at least $50 million and possibly as high as $75 million a month [redacted] 25X1

Lebanon: Balance of Payments, 1981-84 *Million US $*

	1981	1982	1983	1984
Trade balance	−2,404	−2,413	−2,699	−2,117
Exports [a] (f.o.b.)	836	727	691	595
Imports [a] (f.o.b.)	3,240	3,140	3,390	2,712
Overall balance [b]	NA	360	−933	−1,475

[a] Trade partner data.
[b] Estimated from financial flows.

Agriculture probably has the brightest prospects of any of Lebanon's economic sectors. Agricultural sales suffered considerably following Israel's invasion of south Lebanon in 1982. Orchards were destroyed and land was taken out of production for security reasons. In addition, transportation difficulties and boycotts by some Arab countries caused domestic sales and exports to fall. With the Israeli withdrawal, most of the marketing bottlenecks probably will be reduced and more land put into production. The fall of the pound also makes Lebanese farm products more competitive in export markets.

External Accounts May Actually Improve

Prior to 1983, Lebanon ran large trade deficits that were offset by remittances from abroad and by surpluses in the service sector. In the last couple of years, however, remittances, which once totaled more than $2 billion a year, have fallen off considerably as the growing number of Lebanese living outside the country have kept their money abroad. This year, Lebanon's foreign payments position may actually improve. The 60-percent fall in the pound's value against the dollar since last September should cut into import demand and help exports of both agricultural and manufactured products.

There have also been numerous reports of the renewed flow of funds from abroad to militias in Lebanon. This has been especially attributed to efforts by the PLO to reestablish their position within the country. According to one US Embassy report, the consensus of opinion in the Beirut financial community is that the Palestinians brought in some $400 million during April, May, and June but nothing during July and August. If true, this helps explain the partial strengthening of the pound at midsummer. Another Embassy report estimates average monthly flows to Muslim militias of at least $50 million a month. 25X1

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The amount of capital fleeing the country is also likely to decline. Most of the money that could be taken out has probably already left the country. The rapid depreciation of the pound will also discourage further flows. The main factor that would cause renewed capital flows would be an all-out push by the Muslim militias against the Christian heartland, which seems unlikely at the moment. 25X1

Unusual Sources of Income

While Lebanon's economic picture is indeed gloomy, this does not mean that people are without food or that there is not considerable money in circulation. The Lebanese are enterprising and still have sources of funds: 25X1

- The overseas money flowing to the various militias may total as much as $100 million a month, and both Muslim and Christian groups provide employment for otherwise unemployed youth.
- Illegal trade with Syria increases commercial activity and provides income.
- Remittances from Lebanese workers and businessmen abroad still continue, perhaps on the order of $60-90 million a month.

Lastly, there is the lucrative drug trade. Hashish cultivation in the Bekaa Valley has been unencumbered by government control or Syrian interference

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for the last several years. The hashish trade has been estimated to be worth $600 million to $1 billion a year to Lebanon, and some press sources put the total as high as $2 billion a year. Lebanon is also a transit point for cocaine and heroin. [redacted] 25X1

Outlook

The Lebanese economy cannot rebound until the security situation is brought under control. This, however, would require a political accommodation between the various factions that seems far from likely any time in the near future. The government will have to continue to finance its spending through borrowing, which will eventually generate greater inflation. If the civil war remains relatively calm (a precarious assumption), the pound, however, will likely depreciate at a slower rate than it did over the last 12 months. Although this year's foreign payments position may actually improve, infusions of foreign aid needed for rebuilding will remain minimal until Lebanon's political situation is resolved [redacted] 25X1

[redacted] 25X1

Briefs

Energy

Major Soviet Oil Export Difficulties

[redacted]

The USSR last week indicated it will cut total oil exports to the West by as much as 50 percent beginning in October with many customers to be cut off completely, according to Western oil traders. The Soviets did not say how long the reduction in deliveries would last, but many Western traders expect it to continue through the first quarter of next year. There are indications of only marginal disruptions in shipments to Eastern Europe. The export difficulties almost certainly are the result of shortfalls in production, possibly aggravated by a buildup of domestic stockpiles to prevent spot shortages such as occurred last winter. A sharp decline in oil exports for the rest of the year, combined with lower oil prices this year, could cut Soviet hard currency oil sales by as much as $3-4 billion for 1985. Moscow will probably be able to satisfy its Western import requirements for 1985, but continued shortfalls in earning will cut its purchasing power for the next couple of years unless Moscow takes further action—such as aggressive borrowing. [redacted] 25X1

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Iraqi Aqaba Pipeline Negotiations Stalled

[redacted]

Prospects for construction of the 1 million b/d Iraqi-Jordanian pipeline remain poor despite the latest efforts by a US firm to revive the project. In comments to a US delegation in Baghdad, an Iraqi Ministry of Petroleum Undersecretary was critical of an estimated $200 million increase in project cost and the small US equity in the project. Oil market and technical factors also weigh against the project. Baghdad is beginning operation of its 500,000 b/d line to Saudi Arabia's Red Sea port of Yanbu and is likely to increase export capacity another 500,000 b/d in early 1987 with the expansion of its Turkish export pipeline. Possible completion of the second phase of the Iraqi-Saudi line would add another 1.1 million b/d to Iraqi capacity. Limited northern oilfield productive capacity would require a costly additional pipeline to southern fields to enable efficient use of the proposed line to Aqaba. [redacted] 25X1

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China Developing Offshore Gasfield

[redacted]

[redacted] 25X1

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China Increases Productivity at State Coal Mines

Beijing has increased productivity at its state-run coal mines by increasing mechanization, introducing wage incentives, and reassigning unproductive workers. Last year, state mines, which produced about half of China's 772 million tons of coal, increased their output 4.3 percent over 1983 in spite of a 5-percent cut in the work force. Beijing this year expects state mines to increase output slightly with even fewer miners. Many of these productivity gains are a result of the introduction of foreign equipment from the United States, Poland, and West Germany. To achieve its goal of producing 1 billion tons of coal per year by 1990, China will need to import significantly larger quantities of foreign equipment and will probably seek more low-interest loans—such as those provided by Japan—to finance these purchases.

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International Finance

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Costa Rica's Financial Squeeze Eased

San Jose regained access to IMF funds last week by renegotiating the standby program it lost last July, but we doubt that President Monge, facing the end of his term next May, will be able to deliver on austerity promises. The administration agreed to sharp spending cuts, new budget controls over state enterprises, revised interest rate policies, and a freeze on public-sector wages.

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The accord reopened San Jose's access to World Bank and commercial bank loans needed to reduce debt arrearages and maintain critical imports. Establishing controls over state enterprises—which will require approval from an uncooperative National Assembly—will be particularly difficult. Moreover, the government has assured the public that neither salaries nor exchange rates would be modified, and that public expenditures would continue at projected rates. [redacted] 25X1

Sudan Fails To Reach Accord With IMF

[redacted]

A high-level meeting between the Sudanese Government and an IMF delegation ended in failure last week. [redacted] Khartoum 25X1
was unwilling to agree to badly needed economic reforms, including a rise in gasoline taxes and an agreement in principle to adjust its export exchange rate. The impasse raises, again, the threat of a suspension of Sudan's IMF 25X1
membership. This would likely make coordination among donor countries even more difficult, and compromise further Sudan's ability to attract financial assistance. The IMF will review no later than 25 October a previously made decision to limit Sudan's use of the Fund's general resources, and it may also declare Khartoum ineligible to receive any financing unless an acceptable economic reform program can be agreed upon. Khartoum's overdue financial obligations to the IMF currently total over $150 million. [redacted] 25X1

Morocco's Financial Problems Abate

[redacted]

Agreements reached last month with the IMF and Paris Club members have snatched Morocco from the brink of a major debt crisis and opened the way for debt negotiations with commercial creditors. Morocco's IMF package provides $116 million immediately and another $200 million over the next 18 months under a standby arrangement. Paris Club members agreed to provide debt relief through February 1987—a departure from previous one-year Paris 25X1
Club reschedulings. The complicated nine-year rescheduling allows four years' grace and covers 90 percent of the $2 billion in service payments due during the period. [redacted] negotiations 25X1
with London Club members could result in a generous agreement covering about the same amount of Morocco's commercial debt. The US Embassy reports that initial local reaction to the IMF and Paris Club actions has been favorable, but resulting budget cuts almost certainly will result in lower living standards, which will increase the possibility for unrest this winter. [redacted] 25X1

Pakistan Declines IMF Standby Loan

[redacted]

Bouyed by a recent gain in reserves, Pakistan declined an IMF standby loan during negotiations last month. The Pakistanis argued that the IMF targets—including a devaluation, a reduction in domestic subsidies, and higher taxes—were politically untenable during the transition to a more representative 25X1
government. Pakistan's foreign exchange reserves had fallen to about $400 million in mid-August—less than one month's imports—but have now more than doubled because of the success of new foreign currency bonds and capital increases in foreign banks, according to the US Embassy. The infusion of capital has bought Islamabad some time, but there is little chance of substantial export or worker remittance growth. The situation will deteriorate rapidly unless the government undertakes some economic reforms and cuts back on imports. [redacted] 25X1

Global and Regional Developments

Foreign Advances in Auto Engine Technologies

[redacted]

Automakers in Western Europe and Japan are taking steps to significantly improve performance and fuel efficiency in their auto engines. Engines with four valves per cylinder will be available in the US market for 1986 from Volkswagen, Mercedes-Benz, Porsche, Saab, Lotus, Ferrari, Honda, and Toyota for use primarily in their high-performance cars. Audi, Mazda, Mitsubishi, and Nissan are in the latter stages of developing similar engines. Toyota and Honda use a three-valve-per-cylinder design for their smallest and most fuel-efficient gasoline engine. US production is at least two model years away. While US producers could achieve four-valve performance by applying standard turbocharger technology, the Europeans and Japanese are ahead in combined four-valve-turbocharge technology. We believe that foreign manufacturers will increase their domination of the US high-performance auto market in the next few model years. [redacted]

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Yugoslav-French Auto Venture Failing

[redacted]

The Yugoslav automaker IMV may terminate its joint production agreement with the French firm Renault. Under the present arrangement, IMV assembles Renault R-4s for export to France using French engines and drive trains. Yugoslav components have not been able to meet Renault quality standards and IMV has had to import these parts, leading to higher production costs and losses last year of $10 million on sales of $97 million. Crvena Zastava (maker of the Yugo-55 recently introduced to the US market) is interested in acquiring IMV's production facilities. While Belgrade has hopes for economic recovery through high-tech joint ventures, IMV's failure could dampen foreign investor enthusiasm for such schemes. [redacted]

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Chinese-Canadian Ultralight Aircraft Venture

[redacted]

China has entered into a $6.5 million joint venture with a Canadian firm to manufacture 500 ultralight aircraft employing Chinese materials and Canadian designs. Although initial plans call for the ultralight to serve as a crop duster, China has an eye on the export market. Under the agreement, the Canadian firm is charged with developing foreign markets for the ultralight stressing its uses in aerial photography, rescue work, agriculture, and pilot training. The low detectability of ultralights may also make them useful in some combat support roles. [redacted]

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National Developments

Developed Countries

[redacted]

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Strong Canadian Growth Continues

The Canadian economy expanded at a 4.2-percent annual rate in the second quarter, and for all of 1985 is now expected to grow at least 1 percentage point faster than the 3.1 percent forecast by Ottawa last May. Unlike 1984's 5-percent growth, which was primarily generated by increasing exports to the United States, the present expansion is fueled mainly by rising domestic spending. Final domestic demand jumped 7.1 percent in real terms in the second quarter, and construction, which had been sluggish the past two years, leaped by 35 percent. Growth in the second half of 1985 should remain strong because inventories are low and exports should improve. The US economy is expected to pick up this fall, and the US dollar is generally anticipated to depreciate further, pulling the Canadian dollar down with it.

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Italy Introduces 1986 Budget

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After a month of sometimes contentious debate, the Italian Cabinet has agreed on a budget proposal for 1986 that would stem the growth of Italy's massive public-sector deficit, now 15.7 percent of GDP. The plan calls for slightly lower income taxes to be offset by a $4.4 billion cut in social spending. Italians will pay more of their medical and transportation costs and contribute more toward social security to prevent the deficit from rising above the projected $55.4 billion, or 14.5 percent of estimated GDP. The budget proposal is a politically strong step toward addressing Italy's budget problems. In Parliament the Communist Party will strongly oppose the spending cuts and is likely to pick up enough support from sympathetic leftist members of the coalition to force the government to backpedal. In his two years in office, Prime Minister Craxi has been unable to reduce the budget deficit; another failure will undermine confidence in his ability to direct economic policy.

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Sweden Moves To Restructure Industry

With a general election over, the Palme government has now begun to place greater emphasis on forcing Swedish industry to restructure and become more competitive. Stockholm has announced that it will stop all state assistance to the shipping sector, as well as to private firms in other industries that encounter financial troubles. In a major move, the government has decided not 25X1 to rescue Consafe—the world's largest lessor of floating platforms and other rig equipment—from bankruptcy. The government's Ship Credit Guarantee Board loan guarantees, worth $235 million, cover more than 80 percent of Consafe's debt. The Consafe failure will contribute to the problems of Sweden's three state-owned shipyards and could lead to closure of two, Ardenal and Kockums, that already are in shaky financial shape. If the government lets these yards fold, Sweden will no longer be a major player in offshore platform construction. [redacted] 25X1

Less Developed Countries

Egypt Considers New Economic Moves

The government of Prime Minister Lotfi is already under considerable pressure to demonstrate economic progress amid signs of growing public discontent. Uncertainty over future import policies has contributed to abnormally heavy purchases of dollars in recent weeks by both private- and public - sector companies and has sparked a sharp 20-percent depreciation in the free market rate of the Egyptian pound. Moreover, the US Embassy reports the 25X1 government is increasingly worried about the possibility of social unrest over further price increases for food and consumer goods. Lotfi could effectively ease the exchange-rate crisis, which has already moderated somewhat, by introducing a genuinely flexible commercial-bank rate. A move toward a unified exchange rate would, however, eventually raise the cost of Egypt's exorbitantly expensive subsidy system and produce even more pressure for politically dangerous price increases. Instead, the government may again seek a stopgap solution, permitting some additional flexibility in bank exchange rates and allowing only very gradual consumer price increases. [redacted] 25X1

Pakistan Sends Military Technicians to Iran

Pakistan, in return for lower priced oil, has agreed to send between 50 and 100 military technicians and advisers to Iran to help repair damaged military equipment [redacted] Islamabad also has approved 25X1 Iranian purchases of small arms and spare parts from private Pakistani arms dealers; previously it had turned a blind eye to the practice but had not 25X1 officially allowed it. Pakistan reportedly refused to give Iran as many technicians as it asked for and will not sell the arms openly to avoid offending Saudi Arabia and Iraq. While the government has shied away from sending military-related personnel to the warring states, Pakistan's foreign payments problems nonetheless are making expanded economic ties to Iran, already a major trading partner, increasingly attractive. Islamabad probably will not go much beyond the present agreement, however, to avoid jeopardizing relations with Saudi Arabia. [redacted] 25X1

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Communist

Moscow Fails To Fulfill US Grain Agreement

[redacted]

Despite assurances given the US Secretary of Agriculture in August, Moscow has not purchased the remaining 1.1 million metric tons of US wheat called for in the second year of the US-Soviet long-term grain agreement. The Soviets are required to make annual minimum purchases of 4 million tons each of wheat and corn under the agreement, which went into effect 1 October 1983. Soviet officials are dissatisfied with their exclusion from the US Export Subsidy Program and want a discount similar to the $22 per ton recently offered Egypt. [redacted]

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Soviet Steps Toward Industrial Modernization

[redacted]

General Secretary Gorbachev's modernization campaign is being translated into concrete programs and is reaching far down into industry. [redacted] the Minister of Nonferrous Metallurgy—responding to a decree by the Council of Ministers—in early September ordered a review of all construction projects under his jurisdiction that would be under way during the 1986-90 plan period. The review had to be concluded by the end of November and was undertaken to ensure that all construction projects met criteria for modernization. A plant official who complained that the review would bring all his work to a halt was told the review applied to the whole USSR. A quality review alone, however, will not assure speedy modernization; success also depends on changing the incentive program to reward workers for renovation and on industry's ability to deliver advanced production equipment. Indeed, the complaint about likely work stoppages indicates that the review itself will be disruptive. [redacted]

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USSR Seeking Foreign Agricultural Technology

[redacted]

The Soviets recently signed a long-term agreement worth as much as $1.3 billion with a US-based multinational firm to purchase Austrian-produced corn seed. The Soviets may buy up to $60 million worth of corn seed a year by 1990 and $120 million by the year 2000. In addition, the firm will build turnkey facilities for producing and processing corn seed in the USSR—worth about $300 million. Austrian officials claim the plant and the purchases could supply up to 15 percent of Soviet requirements by the year 2000. This first Soviet long-term agreement to buy foreign seed is in line with General Secretary Gorbachev's policy to acquire Western farming techniques. Soviet failure to modernize its agrotechnology has thus far limited production of corn, even in areas where corn yields are greater than those of other crops. In addition, indirect benefits the Soviets will receive—knowledge that will improve crop breeding, seed raising, and production practices—may far exceed the direct benefits. [redacted]

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Polish-Soviet Cooperation Accords

The USSR and Poland signed an agreement last month to cooperate in industry and technology over the next five years. Warsaw and Moscow have selected seven priority areas and 85 specific projects on which to concentrate research, including electronics, energy, biotechnology, and the consumer good and machinery sectors. Research goals include the development of aircraft guidance systems, digital color televisions, and new varieties of grain, food, and drugs. Cooperation will continue on many of these same projects past 1990. These agreements, as well as several sectoral accords signed earlier this year, seem to be elaborations of the long-term program for the development of economic, scientific, and technical cooperation through the year 2000 signed in May 1984. Such cooperation, however, could be a drain on Poland, which needs to invest in projects more oriented to the Western market to increase hard currency exports and pay its debts.

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Chinese Communist Party Approves Seventh Five-Year Plan Proposal

Recent high-level party meetings in Beijing approved an outline of the Seventh Five-Year Plan (1986-90). According to Premier Zhao Ziyang, the actual text of the plan will be formally approved next spring by China's rubberstamp legislature. The proposal reaffirms the leadership's commitment to comprehensive economic reform, while calling for containment of currently overextended capital investment and urging an end to the thorny problems associated with excessively high growth rates. Specific reforms include:

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- Expanding enterprise decisionmaking powers and relaxing the state's control.
- Greater use of monetary and fiscal policy, and strengthening the nation's banking, auditing, and statistical systems.
- Completing price reform by 1990.
- Continuing China's "open policy" of expanding foreign trade, promoting increased foreign investment in the special economic zones, and making greater use of foreign borrowed funds.
- Creating a social safety net to minimize reform-related personal hardship.

The few growth targets cited are not ambitious. Overall economic growth is planned to increase at a 7-percent average annual rate, with agricultural output growing by 6 percent and industrial production by 7 percent. Comments made during the party meeting by senior leaders, however, suggest that disagreement will continue between reformers and conservatives over the future course of China's economic reform program.

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China's Trade Deficit Controversy

China's State Statistical Bureau (SSB) has predicted a trade deficit of $18 billion for 1985, although a more realistic estimate would fall below $12 billion. The SSB projection appears to be an overstated straight-line projection of midyear levels. Beijing, however, began to cut imports after a first-quarter deficit of $2.5 billion and concerns that foreign exchange reserves were falling too fast. Moreover, China's exports generally rise toward yearend, which would further reduce the trade gap. China's Ministry of Foreign Economic Relations and Trade (MFERT) strongly criticized the SSB projections. MFERT, because of anxiety among the national leadership over foreign exchange levels, is probably maintaining efforts to curtail imports.

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Military Joins in Chinese Airline Competition

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United China Airlines (UCA)—created, staffed, and maintained by the Chinese Air Force—has joined the growing number of local air carriers competing against the national airline, the Civil Aviation Administration of China. The fledgling airline operates a fleet of aging Trident and Soviet passenger planes from makeshift terminals created at military airports. 25X1 According to one senior UCA official, the airline is barred from domestic civilian airports except in Jiangxi Province, where the provincial governor has lifted the ban in an effort to attract tourists from Hong Kong and Macau. UCA now flies routes between Huiyang (near Hong Kong) and Xian, Hangzhou, and Beijing. [redacted] 25X1

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Cambodia Devising a Five-Year Plan

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[redacted] the Vietnamese-backed regime in Phnom Penh 25X1 is setting goals for its first Five-Year Plan (1986-90) pegged to Vietnam's announced timetable for pulling its troops out of Cambodia [redacted] 25X1 [redacted] regime plans call for self- 25X1 sufficiency in food production as well as creation of an army capable of defending the country without outside assistance by 1990 [redacted] 25X1 also that Phnom Penh is not considering a rigid, Soviet-style economic system, but intends to promote a more open market-oriented economy—a move that, we believe, reflects recognition of reality. We believe, however, the targets will remain far beyond the regime's capabilities. Cambodia, for example, may succeed in avoiding widespread starvation, but the country remains critically short of necessary agricultural inputs and infrastructure—or the foreign exchange to buy them—that would assure self-sufficiency in rice. [redacted]

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